John O'Sullivan, Chair, Australian Investment Banking Division, Credit Suisse, Sydney

Conflicts of Interest in financial Services Firms – a commentary

CONFLICTS OF INTEREST IN FINANCIAL SERVICES FIRMS

A COMMENTARY

BY

JOHN O'SULLIVAN*
Chairman, Investment Banking
Credit Suisse (Australia) Limited

* The views expressed in this paper are the author's alone and do not necessarily reflect the views of his employer.

I am indebted to your President Diccon Loxton for pointing out to me that, having defected from the law to investment banking, I could borrow from Judy Collins, and call my talk “Both Sides Now”. And it is true that I have looked at conflicts from both sides now, from up and down, and still somehow its conflicts illusions I recall. I really don’t know conflicts at all.

Only some of you are old enough to appreciate that ñ but Iím sure all of you will appreciate that I didn’t sing it.

Though I have been asked to address conflicts in financial services firms I would like to paint a slightly larger canvas. Emboldened by Bob Baxt’s reminiscences about my former partner Bob McComas and by the somewhat sniffy comments by Justice Byrne in the Village Roadshow case which Bob also quoted, I am going to start with a quick look at conflicts in the legal profession. I will use that as a basis for some broad generalisations about the policy underlying conflicts and then talk about financial services firms.

The Pope has just been in Sydney and that is a good enough reason for me to ask the lawyers here to examine their conscience. In particular to ask which of you is without sin and is thus happy to cast the first stone.

As Bob has pointed out lawyers face terrible conflicts, though in my experience they get much less publicity than those faced by investment banks. The Citigroup case is much better headline material than whether a law firm can act against a former or current client.

But any partner in a law firm who has ever been asked by a major client to give a legal opinion which stretches the truth ñ or bends it completely out of shape ñ knows what I mean. Your financial interest in preserving a profitable client relationship runs smack bang up against your duty to the court. Barristers are no different ñ we have all come across barristers whose opinions can be purchased.

And commercial conflicts between clients abound. How often are partners in law firms called on to decide whether to act for client A or client B in situations where A and Bís commercial interests (though not necessarily legal interests) collide? Law firms of any size have conflicts committees to decide these questions. If we are honest with ourselves we would admit that it is very tempting to make the choice based on which client is most valuable, not on which client has the best call on our loyalty.

In defence of the legal profession I believe ñ though I have no evidence for it one way or the other ñ that the percentage of lawyers who prefer their interest to their duty is small. Nor do I wish to be unduly sanctimonious about this. In the confessional spirit I will admit to one or two occasions in 25 years of practising law in a major law firm when I may have polished up an ordinary argument more than was strictly appropriate, when I sugar coated a bitter pill, when I did a little soft shoe shuffle around the unvarnished truth, in order to keep a client happy. And I am sure I found rationalisations that enabled me to feel good about choosing the remunerative client over the deserving one.

What is my point, you ask? Simply this. Conflicts are part of life. If you don't have major conflicts regularly you either are not smart enough to identify them or you're not playing first grade.

And whilst I accept there are some conflicts that are so egregious they must be prohibited, they are few. Most can and should be managed, using tools such as disclosure and consent, and maintenance of information barriers.

You see we as a society must understand the price of ideological purity. Byrne, J told only half the story when, in the passage Bob quoted, he said "It is a notorious fact that a good deal of commercial litigation in Victoria is conducted by a handful of very large firms … this is the price which the clients of such firms and the firms themselves must pay". In harking back to the golden days of cottage industry law firms and Lord Lindley on Partnership, Byrne J (with the greatest of respect) falls for what some sociologists call "noble savage myth". The myth that the old days were purer, simpler and happier than today.

The truth is that society as we know it today needs large full service law firms with whirring computers and hundreds of lawyers ready to be swung onto the due diligence for the BHP/Rio takeover. The size and complexity of law firms simply reflects, and is a response to, the complexity of modern commercial life. To return to the sweet simplicity of yore, as Justice Byrne would clearly like to do, would impose a significant cost not only on law firms and their clients, but on society. Less efficient law firms will mean less justice not more. A legal profession of one man firms would be slow, could not afford the efficiency of modern technology and would cost jobs. A Luddite legal system would bring commerce, and the jobs and wealth it creates, to a halt. The same is true of financial services firms to which I shall come in a moment.

Before I do, let me illustrate my point a little further by travelling to the field of private equity. This time last year, at a different conference in what seemed a happier, simpler pre-credit crunch time, I listened to a paper by Neil Young QC on "Conflicts of Interest in the Context of Private Equity Transactions". In a sobering analysis of the difficult conflict issues faced by public to private bids, especially those sponsored by private equity firms, Neil highlighted in particular those conflicts faced by incumbent management who are promised participation in the bid vehicle. Citing Furs Ltd v. Tomkies (1936) 54 CLR 583, he concluded that unless shareholders in general meeting give fully informed approval to such an arrangement the executives must account to shareholders for any profits they receive as a result.

Neil Young pointed out a "director or senior executive who makes a profit of this kind cannot avoid liability by contending that, in overall terms, the transaction was fair and beneficial to the target company". He acknowledges that in this respect, English and Australian law differs markedly from United States law.

I certainly would not argue the legal toss with Neil Young. I probably would not have done that even when I was a real lawyer. But I would say that if Australian law does make public to private transactions impossible because of rules such as this, that is the wrong answer from a public policy point of view. While it may make those who (like former German vice-chancellor Franz Muntfering) think private equity firms are "locusts", feel better, using fundamentalist views about conflicts to punish the marauding private equity hordes, may actually hurt Australia and Australians.

I know that some will say that it is outrageous that senior management of a listed company can take it private and make it more profitable in their hands than it was in public hands. Any extra profit that they could find in private ownership should be able to be made in public ownership too. If management have smart ways to make money they should exploit those techniques for the benefit of public shareholders.

This fundamentally mistakes the difference between public and private companies. The risk-reward tradeoffs, the appetite for debt and the ability to take decisive, perhaps unpopular action differs so vastly between public and private companies that the two kinds of company are essentially different forms of business vehicle.

And our society badly needs the discipline of private equity owned firms.

A survey done by PWC in 2006 shows that acquisition by private equity firms significantly enhances investor companies' levels of innovation and growth in employment. So it is fine to prefer the Australian approach to conflicts in private equity transactions to the US approach if you want your children to have worse job prospects and fewer new products.

Ditto with financial services firms. Ideological purity will have its costs.

Now don't get me wrong. I am not by any means advocating an open slather, back to the frontier, free-for-all on conflicts. I merely seek balance and some recognition that an unduly puritanical view on conflicts will have significant economic and social costs.

In my mind, the high water mark of conflicts fundamentalism was ASIC's case against Citigroup, to which Bob has referred. ASIC clearly disapproved of an investment bank engaging in proprietary trading of shares while simultaneously providing M&A advice. At the heart of its case was a belief that the nature of the relationship between an M&A adviser and its client was fiduciary and incapable of being contracted away except by extraordinarily clear language.

While directed at the conflicts between advisory and proprietary trading, let there be no mistake that ASIC's challenge was to the very business model of full service investment banks. Essential to the model is that investment banks house a number of different but related businesses, some of which are agency businesses and some of which are proprietary businesses. And while my comments, and ASIC's charges, were directed at investment banks, personal experience tells me that commercial banks are similar.

The complexity of today's financial services firms is such that conflicts between the interests of clients on the one hand and the interests of the firm on the other hand, or between the interests of different clients, are inevitable. Just as conflicts in law firms are inevitable.

As a reformed lawyer, I do not intend to agonise about when a fiduciary relationship exists and what impact that may have on conflicts. Bob and Paul's papers cover that territory admirably. My point is that irrespective of the legal characterisation, commercial conflicts are inevitable.

You could avoid these conflicts by unbundling financial services firms. You could make them operate as monolines ie. single business line, standalone operations. You could impose this form of purity by enacting a "mother of all Glass-Steagall statutes", thus forcing M&A firms to operate separately from research, sales and trading, asset management and proprietary trading. This would be possible ñ but not desirable. While I admire the boutique, single line businesses like Caliburn and Platinum Asset Management (to name but two excellent firms), and hope they continue to prosper, we need full service firms too. Full service firms add enormously to the strength and resilience of today's financial markets. Full service firms have global reach. They have the capital necessary to pay for the risk management, research and analytics and compliance necessary in today's world (not that the risk management is always foolproof). They can use their own capital in proprietary trading to ensure the markets operate with the ruthless efficiency that makes such a contribution to our standard of living. They can put their capital at the service of clients to help transactions happen.

So while I certainly do not argue all financial services firms should be full service, I do argue that we would be much worse off if full service firms were not permitted or were unduly restricted.

For full service firms to be permitted we must acknowledge and accept two propositions:

1. That conflicts are inevitable
2. That most conflicts can be managed and do not need to be prohibited.

The ASIC approach that many conflicts can only be cured by the most extraordinarily detailed confessions and consent is, in my view, not merely unworkable but undesirable. By setting a standard of consent so absurdly high it could, in practice, never be jumped, ASIC would send our financial services industries back if not to the Dark Ages, at least to Victorian times. Justice Jacobson not only got the right legal conclusion, if I may respectfully say so, but also the right policy result.

Now I must repeat that I do not scoff at conflicts and I do not advocate a laissez-faire approach. In my firm and other similar firms we have barriers between investment banking and research that cause frequent angst and loss of business. Investment bankers now dread being told they won't be hired by a client because their firm's research analyst has a "sell" on the client's stock. But they are used to it and accept it. That was a form of regulation made necessary by the excesses of the dot com boom. It was necessary and appropriate, and I certainly do not complain about it.

And I should add that in well run investment banks the solutions to these problems are not merely structural but cultural. Thus when I joined Credit Suisse I discovered structural separation between investment banking and research (as an example) that regulators would find reassuring, indeed perhaps surprising. Indeed not only are there the usual physical barriers and electronic firewalls but as a general rule investment bankers are not allowed to talk to an analyst on a business matter except through the head of research or with a compliance chaperone. But perhaps of even more comfort to me, as a former lawyer, is that a culture has been built under which compliance matters. That is reinforced through education, by example and through performance evaluation.

Nor is the benchmark set merely one of bare compliance with legal requirements. At Credit Suisse, and I'm sure other well run firms, the desire to avoid inappropriate reputational risk drives a high standard of behaviour. I do not say it is perfect. Perfection is usually only available to lawyers ñ and in hindsight. But a true appreciation of how top tier investment banks are run would help regulators understand that the best solutions are as much cultural as structural.

So to conclude, driving full service firms to compulsory unbundling or other similar drastic positions is neither necessary nor appropriate. Generally conflicts can and should be managed. Regulation, like alcohol, is best in taken moderation.